

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
REPLY BRIEF**

Signed

77-4179

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IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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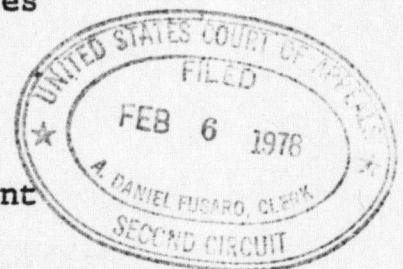
WILLIAM J. McDONALD, SR., and ELIZABETH J. McDONALD,

Appellees

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant



ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

REPLY BRIEF FOR THE APPELLANT

M. CARR FERGUSON,
Assistant Attorney General,

GILBERT E. ANDREWS,
WILLIAM S. ESTABROOK,
THOMAS M. WALSH,
Attorneys,
Tax Division,
Department of Justice,
Washington, D.C. 20530.

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No. 77-4179

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The taxpayer on brief makes two initial arguments: that the Gilmore (Gilmore v. United States, 372 U.S. 39 (1963)) "origin of the claim" test does not apply here, and that even if it does his payments were made for a business purpose and not simply to secure a tax-free legacy^{1/} (Br. 11-16). Concerning the applicability of the Gilmore test, the taxpayer advances a tortuously restricted interpretation of that decision--that Gilmore applies only "where the taxpayer himself incurs litigation expense in the course of prosecuting or defending a claim"

^{1/} The taxpayer fails to explain how a payment of \$121,400 to the contesting heirs can be deductible as having been made to protect his business reputation, but an acquiescence in such heirs' receipt of the entire estate, ostensibly for the same reason, results in no deduction. (Cf. Br. 12, 16-17).

(emphasis in original), (Br. 5)^{2/} a situation which, the taxpayer urges, did not exist in the instant case because (a) "the litigation * * * was not against the taxpayer but against the will" (Br. 5) and because (b) "the payment involved is not a litigation expense" (Br. 9). First, the Government is in total agreement with the taxpayer's initial observation--that the objectants' claim originated as a suit challenging Mrs. Leckie's competence to make the will which bequeathed the taxpayer and his wife the residue of her estate. It is precisely because the origin and character of this suit was personal, dealing as it did with the right of the taxpayer to receive Mrs. Leckie's residuary estate, that the Government contends the Gilmore decision is dispositive of this case. As noted in the Government's opening brief, page 10, the Supreme Court in Gilmore v. United States, 372 U.S., p. 49 ruled, without qualification of any kind that "the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was 'business' or 'personal.'" As to the taxpayer's argument that the Gilmore decision is inapplicable because the \$121,400 expenditure was not a litigation expense incurred by the taxpayer himself, individually, this contention would also appear to concede the taxpayer's case. First, the Gilmore

^{2/} But cf. brief, page 17, urging that "the taxpayer in his individual capacity * * * agreed to make the payment in question."

rationale has been very broadly applied, as shown in the Commissioner's opening brief, pages 10-11, and cannot be restricted solely to payment of litigation expenses. Indeed the Gilmore test was based upon three earlier Supreme Court decisions, one of which (Deputy v. Dupont, 308 U.S. 488 (1939)) concerned the disallowance of payments made by a taxpayer to satisfy an earlier undertaking, and not expenses of litigation. Moreover, it is difficult to comprehend any substantial difference between a taxpayer's payment of legal fees, and a taxpayer's payment of the underlying judgment which necessitated such fees, insofar as the question of business deductibility or personal nondeductibility is concerned. Cf. Clark Oil and Refining Co. v. United States, 473 F. 2d 1217 (C.A. 7, 1973); Anchor Coupling Co. v. United States, 427 F. 2d 429 (C.A. 7, 1970); Kimbell v. United States, (C.A. 5, 1974); Fischer v. United States, 490 F. 2d 218 (C.A. 7, 1973). Also see, Woodward v. Commissioner, 397 U.S. 572 (1970). Finally, since the taxpayer concedes on brief that his payment of \$121,400 was made in his fiduciary capacity,^{3/} it is clear that he is not entitled to a deduction on his individual return for a payment of principal to the beneficiaries. Such a

^{3/} Since the compromise agreement stated that two of the objectants would be "paid one-half of the principal of the Trust Fund [of the decedent's will] * * * as of the date of appointment of the executor" (R. 20) and the Surrogate's order approving the compromise authorized the taxpayer to settle the controversy by making "payments out of the principal of the estate" (Commissioner's opening Br. 23) there is evidence in the record to support this statement.

payment is only deductible on the estate's income tax return, and even then only to the extent that the estate has "distributable net income". See Sec. 661(a), Internal Revenue Code of 1954.

Secondly, the taxpayer urges that even if the Gilmore rationale applies, the payment to the objectants qualifies as a business expense because "the claim involved is so intimately connected with the taxpayer as an attorney", (Br. 11), in that taxpayer's "professional activities." (Br. 12) In attempting to support that assertion, the taxpayer states that the objections to the will included a claim that the codicil was improperly executed. (Br. 15.) The record contains no support for that statement, because these objections were not made part of the record; instead, they are sealed along with all other papers pertaining to the will contest proceeding, and they can only be inspected by order of the Surrogate's Court and upon notice to the taxpayer. (Order, p. 2; Appendix to Commissioner's Br., p. 23.)

Also, although the taxpayer concedes that the objectants' motives are irrelevant, he nonetheless speculates that they might possibly have foregone their challenge except for the fact that the taxpayer drafted the codicil, which merely revoked a bequest to a party who was not among the objectants to the will. (Br. 13.) This speculation is based upon the taxpayer's reasoning that a codicil republishes the will, so, according to the taxpayer, an attack upon this will must be deemed an attack upon the taxpayer's professional activities. (Br. 14-15.) However, as shown by the

authorities cited by the taxpayer, the principle that a codicil republishes a will is used to determine which of competing documents was a decedent's will; it does not in any way transform the will which the taxpayer did not draft into one which he did draft. Also, the codicil would not have induced the disappointed relatives to attack because it benefitted them by enlarging the residuary estate in which they sought to share. Thus, there is no support in the record placed before the Tax Court for the taxpayer's new proposition that the objectants intended to or did attack the taxpayer's professional activity. Moreover, the Tax Court made no such finding.

Instead, the Tax Court erred by relying upon the taxpayer's motive for settling the dispute, observing only that it was a reasonable business motive because the alleged undue influence, which the Tax Court equated to an "alleged breach of trust underlying the will contest suit" (R. 37), was, in the Tax Court's opinion, "directly connected with * * * [the taxpayer's] practice of law" (Ibid). This observation falls far short of satisfying the Gilmore "origin of the claim" test, for the reasons enumerated in the Commissioner's opening brief, pages 11-16.

Finally, taxpayer's argument (Br. 16-17; but cf. pp. 5-6) that his interest in Mrs. Leckie's estate vested upon her death under state law and that the payment to the objectants came from his funds, is legally irrelevant. Cf. McGauley v. Commissioner, 504 F. 2d 1030, 1031 (C.A. 2, 1974); United States Trust Co. of New York v. Commissioner, 321 F. 2d 908, 910 (C.A. 2, 1963), cert.

denied sub nom. Estate of Davenport v. Commissioner, 376 U.S. 937 (1964). It has long been the rule that property received by taxpayers in compromise of will contests is property received by inheritance. Lyeth v. Hoey, 305 U.S. 188 (1938). And this is so regardless of whether the payment is made by the executor himself, or by the estate beneficiaries who, by such payment, receive the remainder of the estate in return for the compromise payment. See McGauley v. Commissioner, supra; Thompson v. Commissioner, 123 F. 2d 816 (C.A. 2, 1941); Sage v. Commissioner, 122 F. 2d 480 (C.A. 3, 1940), cert. denied, 314 U.S. 699 (1941); Irving Trust Co. of New York v. United States, 221 F. 2d 303 (C.A. 2, 1955), cert. denied, 350 U.S. 828 (1955); Quigley v. Commissioner, 143 F. 2d 27 (C.A. 7, 1944). When the circumstances of this case are examined in the light of economic reality, the amount received by the objectants, whether from the estate or the taxpayer, was nothing more nor less than an inheritance from the decedent. Were it otherwise, the payments received by the objectants would not be exempt from income as in inheritance. Section 102, Internal Revenue Code of 1954. In short, even though the payment of a portion of the testamentary trust fund passed through the decedent's hands--as it assuredly did, either in taxpayer's capacity as executor or as residuary beneficiary--the taxpayer served merely as a conduit for the payment of such amounts. In Lare v. Commissioner, 62 T.C. 739 (1974), aff'd 521 F. 2d 1399 (C.A. 3, 1975), the taxpayer, the sole beneficiary of a will the validity of which was contested by the decedent's heirs, received a check for \$75,000 from the bank which succeeded him as administrator

of the estate, which check he promptly endorsed back to the bank, which in turn issued a check for \$73,360 in settlement of the heirs' challenge to the probate of the will. In rejecting the taxpayer's assertion that he had paid the \$73,360 and was thus entitled to include such payment in the basis of other assets received from the estate as residuary beneficiary, the Tax Court (Judge Dawson) ruled (p. 754) (relying upon McKee v. Commissioner, 19 B.T.A. 430 (1930), cited by the Commissioner in his opening brief, page 17) that "in such situations the will contestants are considered to receive their payments from the estate and the legatee serves merely as a conduit for such payments" and concluded (p. 755)--

The payment to the will contestants from moneys in the estate does not constitute a capital expenditure for petitioner. Neither the facts nor the law supports petitioner's position that he paid \$73,650 to the will contestants in order to procure title to all the stocks in the estate. The will contestants were simply paid a share of the estate from the estate. And, as we see it, the petitioner should not receive credit for the distribution from the estate which went to pay the will contestants.

Indeed, the taxpayer's admission that (Br. 17) "he would not be entitled to a deduction if he had accepted none of the bequests under the Will" amounts to nothing more nor less than an outright concession of his case. Assuredly, the taxpayer's right to a deduction cannot depend on whether the amount received by the disgruntled heirs was, in the first instance, received by the taxpayer as residuary beneficiary and paid by him to the heirs, or whether such amount was received by the taxpayer as executor,

and paid by the taxpayer in his fiduciary capacity to the heirs. See McKee v. Commissioner, supra; Lare v. Commissioner, supra. As this Court in Estate of Thompson v. Commissioner, supra, (pp. 817-818) noted "The fact that the charities [the testamentary remaindermen], rather than the executor, made the payment is immaterial; he was no stranger to the agreement, but even if he were, the effect of the payments would have been no different."

Moreover, the taxpayer's contention that Mrs. Leckie's estate vested in him is factually misleading, because its vesting was contingent upon his obligation to pay the objectants, two of whom were to receive "one-half of the principal of the Trust Fund." (R. 20.) The taxpayer himself represented to the Surrogate's Court that the will and its codicil had been probated (i.e., he had received the estate) "subject however to an Agreement made between the parties" (R. 23), which required him to make payments. In approving the Compromise Agreement, the Surrogate's Court authorized the taxpayer to make the payments from the estate's principal. (Commissioner's Br. 23.) The Compromise Agreement and the Surrogate's order show that a portion of the estate flowed directly through the taxpayer's hands to the objectants, as the law presumes. Nowhere in his appellate brief does the taxpayer address the Commissioner's argument (Br. 18) that these facts show that the taxpayer, having received a tax-free legacy, is attempting to shelter other taxable income by claiming a deduction for the portion of the estate transferred to the objectants, an expenditure which was directly related to the taxpayer's obtaining the tax-free legacy, and which, for that reason alone, is nondeductible.

CONCLUSION

For the foregoing reasons, and for the reasons stated in our opening brief, the decision of the Tax Court should be reversed.

Respectfully submitted,

M. CARR FERGUSON,
Assistant Attorney General,

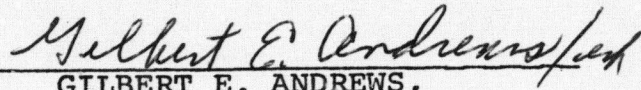
GILBERT E. ANDREWS,
WILLIAM S. ESTABROOK,
THOMAS M. WALSH,
Attorneys,
Tax Division,
Department of Justice,
Washington, D.C. 20530.

FEBRUARY, 1978.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on appellee, appearing pro se, by mailing four copies thereof to him on this 3rd day of February, 1978, in an envelope, with postage prepaid, properly addressed to him as follows:

William J. McDonald, Sr., Esquire
Bond, McDonald & Toole
P. O. Box 228
Geneva, New York 14456



GILBERT E. ANDREWS,
Attorney.